Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

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INVESTMENT STRATEGY AND SELECTION ISSUE

INVESTMENT OUTLOOK: PROSPECTS FOR REAL ESTATE IN A RECESSIONARY ENVIRONMENT

Despite President Carter's assertions that the long-anticipated recession will be short and mild, economic indicators are telling a different story. The prime rate has plummeted 3 percentage points in the last month to 17% (led by Chase Manhattan Bank May 7); the yield on 13-week Treasury bills has fallen to 9.728%, their lowest yield since August 27, 1979, and the yield on the 26-week T-bills fell to 9.495%, the lowest rate since August 13.

Unemployment in April jumped to a seasonally adjusted 7% of the work force, up from 6.2% for March, for the largest monthly rise since January 1975. March seasonally adjusted housing starts plunged 22% from the month-earlier-level to an annual rate of 1.04 million. Perhaps most ominously of all, despite predictions that mortgage rate declines would lag other interest rate falls, Home Savings & Loan (an H.F. Ahmanson unit), the nation's largest thrift lender, has slashed its prime mortgage rate nearly 5 percentage points, to 12-3/4% from 17½%.

But while everyone seems to accept predictions of concurrent downturns in corporate earnings and in real GNP, the stock market has shown remarkable resiliency, reacting more to declines in interest rates than to incipient decreases in earnings. Even the GM dividend cut was swallowed with scarcely a ripple. We just don't think that this will last. Two weeks ago, we said that it was probably worth riding up with the market on the decline in interest rates, and the realty trust stocks, especially the rate plays, have performed well. But in the face of

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the rapidly snowballing drop in business activity, this is the time for the more risk-averse investor to move to a cash/recession proof market position.

While prudence calls for a switch to a recession mentality from an inflationary one, however, inflation cannot be ignored. Those realty trust stocks which are protected from the inroads of a recession are attractive for contained inflation hedging. And with the plunge in interest rates, now is the time to lock in the high dividend yields that some of the trusts afford, while retaining some ability to appreciate.

The different trust groups all have their areas of vulnerability in a recession. While the mortgage trusts have become more attractive as interest rates have fallen, as rising stock prices attest, they run a real risk of defaults in their loan portfolios, especially for those with sizable short-term constructions loans. It was this, more than anything else, that killed the industry during the last recession, in 1974-75.

This won't be repeated. The mortgage trusts to survive that debacle were generally the institutional trusts with high quality portfolios; moreover, the market is not overbuilt as it was five years ago. But a grim scenario painted by the National Association of Home Builders points to danger in the construction loan area.

The NAHB claims that the 22% decline in housing starts does not reflect an exploding cancellation rate. With settlements greatly slowed and new projects abandoned, no new money is coming in at the same time that loan interest keeps accumulating. This also has ominous implications for those trusts whose recovery depends on selling the undeveloped land that they acquired through foreclosure the last time around.

The long term mortgage trusts should be somewhat less risky interest plays. The possibility of foreclosures is much more remote on income generating properties; in addition, market values of these trusts will be enhanced not only by falling interest rates, but also by the gradual rolling over of low-rate mortgages into higher-yielding ones as loans mature.

For the equity trusts, the area of highest exposure is the one that provided the best inflation hedge--the shopping centers. Shopping centers are especially attractive in an inflationary environment as rental income is boosted by overage rents--a percentage of retail sales over a certain minimum level. During a recession, not only may overages largely disappear as retail sales fall, but vacancies may arise as tenants fail. Any increases in gasoline prices would only aggravate these problems.

Office building and apartment building investments carry much less risk. Vacancy rates for office buildings are very low and will remain so, especially during a period of little new construction. Income streams from these holdings should increase, as long-term leases are renewed; there will be little resistance here since rents are a relatively small proportion of business expenses and since there is a dearth of alternatives to coughing up increases.

Apartment buildings also will benefit from a very low vacancy rate and a lack of alternatives--especially when the housing market is dead. Condo potential is not a factor in the short run, because of continued financing costs and recessionary pressures, but income streams should remain steady. The only problem could be the institution of rent control in new cities, which would hamper the ability of management to retain its margins.

Industrial properties have high exposure in a recession; location becomes a critical factor in evaluating risk. The Midwest and Northeast should be harder hit than the Sunbelt or Far West.

The recession also will have longer range effects on real estate markets and

trust portfolios. Smaller shopping centers will become more attractive to develop than the mammoth enclosed malls that were the darlings of the portfolios during the seventies. There are several reasons for this, the most important being that the nation's suburbs are largely saturated with shopping centers, and developers will have to look either to the central cities or to new, exurban communities as locations for the centers. But the cities will have little available land (and that expensive), and the latter will not have the people or the resources to support huge malls. The lower cost of a non-enclosed mall, plus the faster construction and fewer zoning problems that the small centers will afford, will also be attractive.

Along the same lines, look for larger trust holdings of land purchase leasebacks (where the trust retains ownership of a land parcel, leasing it to the owner/developer of buildings on the site). This permits the landowner to retain the inflation hedge aspect of the property, while at the same time the owner or developer of improvements can limit the extent of his investment in the property, generally improving his cash position. This may be the road to recovery for many of the large holders of undeveloped land.

In general, the sound management that carried so many of the realty trust through the 1974-75 recession can be expected to continue. And while those trusts whose appeal lies in being takeover/liquidation candidates may have to sit out this stretch, you can look for many of those trusts with cash to take advantage of depressed market conditions to add to their portfolios.

With these things in mind, let's look at some trusts which appear well-positioned for a recession and its aftermath. First we'll examine some of our No. 1-ranked dividend payers.

American Equity ($12 bid, OTC), had over $51.5 million in real estate assets at 1979 year-end, of which approximately 76% was apartment buildings; over 80% of real estate assets are located in the Sunbelt. In the last 12 months, the trust has paid dividends totaling $1.70/share, for a yield on current share price of 14.2%. Since inception through December 31, 1979, trust dividends have been 63% return of capital, 29% capital gains, and only 8% ordinary income. With the bulk of its assets Sunbelt apartment buildings, cash flow should be recession proof; the high yield and tax free nature of the dividends make these No. 1-ranked shares a buy.

First Union Real Estate ($15.50, NYSE) holds over $200 million in real estate assets, about one-half office buildings and one-third shopping centers. Over the long-term, cash flow will be greatly enhanced by new leases for office space. Potential conversion of $35 million in subordinated debentures at $18 would boost equity albeit diluting earnings; aggressive management and secure 8.3% yield make these shares attractive.

ICM Realty ($15.63, ASE) has about $60 million in land-purchase leasebacks; about half of its assets are apartment buildings, another third are shopping centers. Trust earnings are being boosted by percentage rentals on leasebacks; revenues from these surged 94% in fiscal 1979. Cash flow from income generating investments appears secure, although similar gains in percentage rentals probably won't be repeated. Over time, the trust will benefit from leveraged interest in substantial off-the-balance-sheet real estate; Eastover Corp.'s 26% interest is also a plus. Exposure here is the subordinated nature of the trust's leasebacks (second to financing on buildings), but apartments provide protection; other negatives are bank debt and substantial (31%) nonearning assets. But gains are called for as these are worked out, and the shares are an attractive purchase.

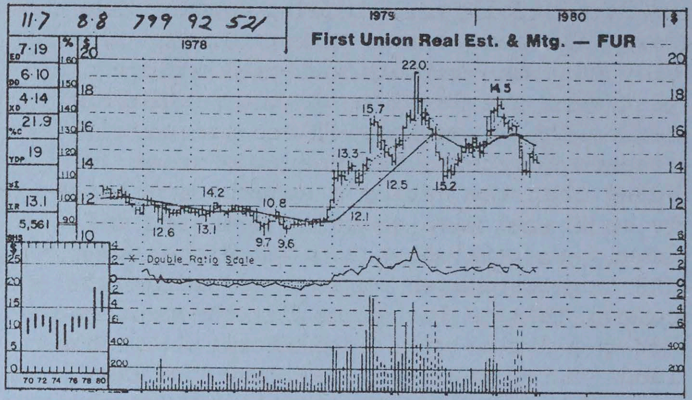
Mortgage Growth Investors' ($10.88, ASE) price is at its 52-week high. The trust has some $50 million in invested

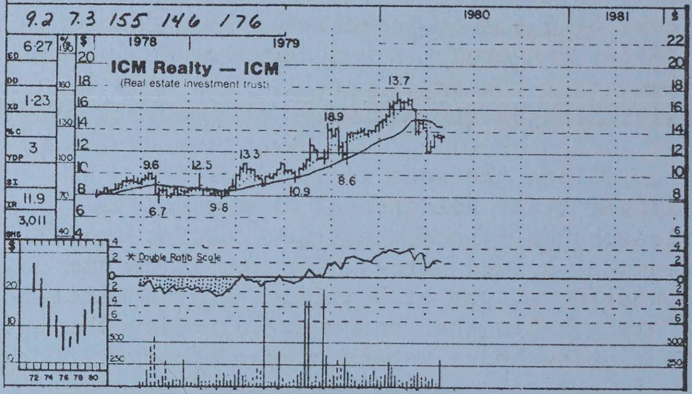
assets, about half real estate equity and half mortgage loans; 77% of the portfolio is in apartment buildings and about one third of the portfolio is in California. Earnings which climbed 65% in fiscal 1979, will continue to be enhanced as new projects come onstream and mature. Equity is being built up, and 1980 should see substantial funds for reinvestment generated with the repayments of mortgages. The trust's strong growth record points to further gains, and with a 9.6% yield, the shares remain recommended for purchase.

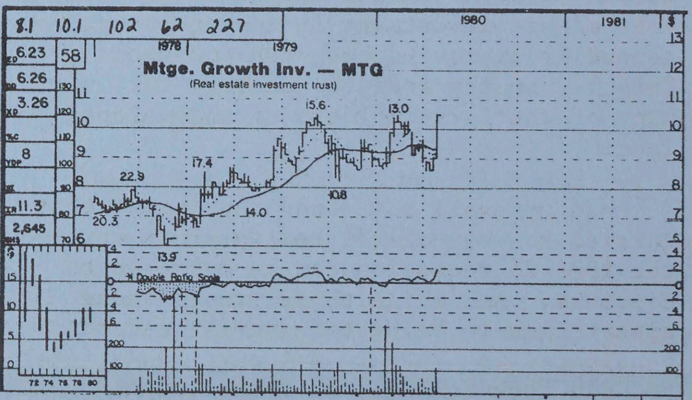
Property Capital ($17.75, ASE) holds $46 million in invested assets, 66% subordinated land leasebacks and 34% second mortgages. While this type of leveraging as with ICM, increases risk in a recessionary environment, the constitution of the portfolio (34% apartments and 29% office buildings) alleviates exposure. Overage rents have climbed rapidly, surging 80% in the six months to January 31, 1980; the trust also will have available a $7.8 million gain on a leaseback sale (if a tax-free exchange is possible) for reinvestment or distribution. While the shares are currently trading 13% below their 1980 high (in February), they are above the highs of the preceding five years, demonstrating strong support. The shares remain an attractive appreciation candidate.

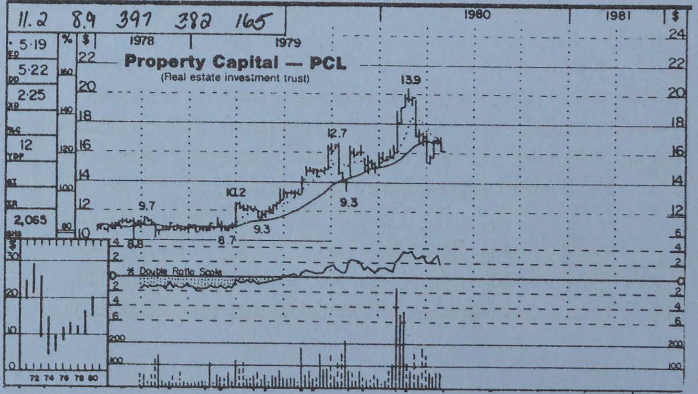
While is relatively easy to set up criteria for selecting among the equity trusts, generalities are much less applicable for the non-dividend paying and/or non-qualified trusts. For this reason, we now examine four of our No. 1-ranked non-dividend paying trusts in light of the current market situation.

Fidelco Growth Investors ($3.50, ASE) is having some well publicized troubles with Sidney Baer, a long-time shareholder who became soured by what he considered mis-management and began buying shares to protect his earlier investment (see block holder discussion, page 6). Until this set-to, Fidelco had swapped assets with all but one of its lenders to repay debt. The only debt left was $20

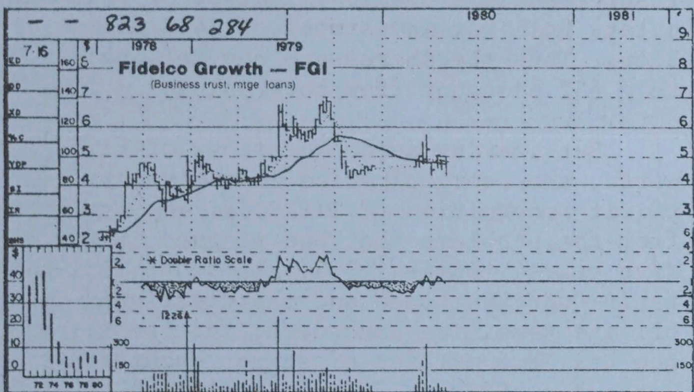


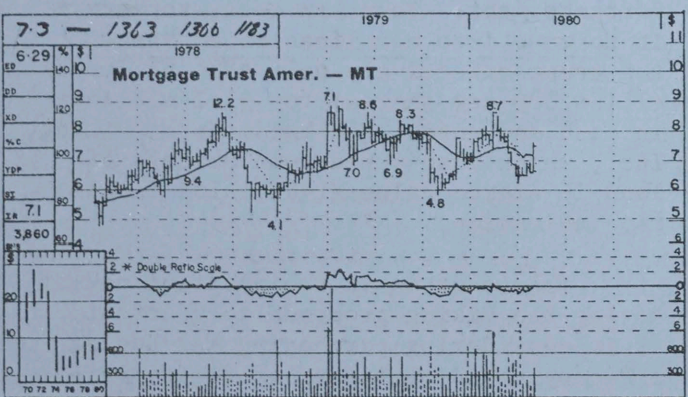


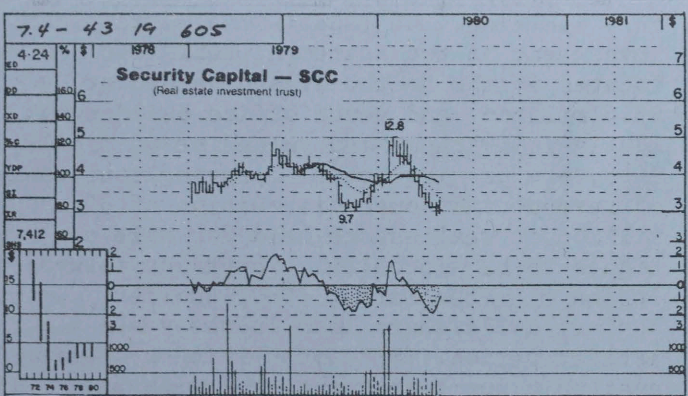




owed to a commercial lending arm of its former sponsor, bank holding company Fidelcor, and we believe that a swap to repay that debt is also likely. Fidelco would be left with several large parcels of development land, and likely would require additional cash or joint ventures to build out these parcels to maximize value. We've ranked them No. 1N because of the good discount from book value, the ability to repay lenders without sacrificing all assets, and the fact that earnings are positive. The presence of Baer







and Lend Lease are plusses, regardless of the outcome of the current battle.

Maryland Realty ($2.13 bid, OTC) is still heavily involved in land holdings in northern Florida, which is a fairly active economic area and has water supply, a much needed commodity. Invested assets are 61% mortgages, all earning; 31% land under development or held for future development (i.e. non-earning); and 9% operating properties, mainly a Leesburg, Fla., office complex. While mortgage loans are earning income, they are not providing market returns. Of the $10.4 million mortgage loans, 47% (or $4.9 million) are with an 8½% interest payable only if cash flow permits, and another 42% (or $4.4 million) are long-term permanent loans with fixed rates from 8½% to 10%. Only one loan for $975,000 (9% of the total) floats with the prime rate. The trust owed banks $8.4 million at April 14, 1980, carrying rates of 12% and 3/4% over prime; debt is secured by a pledge of all assets.

The stock sells about 71% below book value to reflect the fact that the trust would likely have to take about a $3½ million loss (about $4.60/share in our estimate) if it decided to sell/swap its mortgages at market rates and repay banks. To resolve this situation, eliminating losses from negative spread, Maryland is offering its shareholders a right to buy 1.35 shares for each share held (for a total 1,026,000 shares) at $2.25 each (the closing bid price the day before the prospectus was effective). Federated Reinsurance Corp. of Houston, which now holds 24.2% of the trust's shares, has agreed to purchase any unsubscribed shares or to buy additional shares to bring its holdings up to 35% of the then-outstanding shares. The subscription warrants expire May 13, 1980. Proceeds are to be used to restructure bank debt as the trust moves toward becoming an equity trust. Meantime operating losses continue because of high interest rates, although recent reductions may ease pressure. We rank the shares No. 1N because of the potential for raising new money and emerging from their tight position.

Mortgage Trust of America ($7.63, NYSE), has made excellent recovery from the recession and the February quarterly results show good progress in building recurring income. Moreover, it continues to get meaningful recoveries of back interest and repayment of troubled loans, all bespeaking sound initial underwriting of loans and persistence of collection efforts. Trustees are considering whether to continue qualifying as a REIT; we guess that ultimately they will decide to disqualify in order to use their taxloss carryforwards. The sponsor has evidenced continuing support by buying about 6% of the shares. Bank debt is low and so interest rates do not threaten the recovery. Profitable operations assure buildup of book value in the absence of a dividend, and there are no continuing losses to haunt shareholders. The 45% discount from book value isn't the best in the list but the soundness of that book value gives strong hope of recovery. We continue the No. 1N ranking.

Security Capital ($3.50, ASE), has recovered nicely from the recession and earned 18¢/share in the six months through March 31, 1980, against 5¢/share in the year-earlier six-month period. Some part of the earnings come from use of taxloss carryforwards but this again indicates good recovery. Management is regarded as very capable and while it has been criticized for buying a large block of stock last year below book value, the sale gives management a strong identity of interest with the shareholders. The trust recently agreed to buy a Houston savings and loan, Benjamin Franklin Savings Association. While thrift institutions are somewhat suspect in today's economy because of their specialization in home finance, the Texas thrifts in general have much broader lending powers. But in light of current market conditions, Security lowered the price it was to pay for the S&L from $20 million to $15 million, of which $12 million would be in cash and the balance in notes or land. This purchase in a depressed market should enhance earnings as the interest rate squeeze abates, although the sale is not expected to be completed until late 1980 or early 1981. We continue the No. 1N ranking because of the positive dynamics for aggressive capital gains investors.

TIERCO ($3.63 bid, OTC) effected a quasi-reorganization as of January 1, 1980, which added a net $4.6 million to shareholder equity ($1.96 a share), raising per share book value to $9.74 from $7.80. This was achieved largely through the elimination of a $1.9 million loss reserve and the upward valuation of real estate held for investment of $4.3 million. Thus the shares are now selling at a 63% discount from book value.

But leaving aside questions of real worth, the reorganization does give explicit recognition to TIERCO's recovery from the problems that had plagued it for five years. During 1979, all trust litigation was concluded and the trust paid off its remaining bank debt; the trust now has $8.5 million of senior secured notes due 1985 at 10% and $3 million of mortgage debt. Then, in order to permit it to move into new lines of business, the trust effectively sold 48% of itself (1,160,000 new shares) for $7.7 million in cash and notes, the holdings of Viking, Inc., which also owned some parcels of land in Alaska value at $621,281 in the reorganization.

The trust is in the position now of having the Viking proceeds to reinvest; it is considering purchasing TAB Books, a Pennsylvania publisher of do-it-yourself manuals in electronics. Pending this decision, the trust's real estate investment of two apartment buildings located in the Southwest and valued at $5.4 million, and seven office buildings, mostly in Oklahoma and valued at $5.5 million, are proving to be improving sources of revenue, although disposition of $6 million of real estate held for sale continues to be a problem. The trust earned 1¢/share in the March, 1980, quarter, against a 27¢/share loss in the year-earlier period. With its Viking proceeds available for investment, and with the

cessation of losses to erode book value, we continue the No. 1N ranking.

REITS IN THE NEWS: BLOCK HOLDINGS STOCK PAIRINGS, ACCOUNTING CHANGES

Latest doings among the realty trusts include the following:

In our April 11, 1980, Relative Appeal Ranking issue we downgraded the ranking on Commonwealth Realty from No. 1 to No. 3. Since that time we have received a question from a subscriber asking for the reason behind our downgrading, so we'll take this opportunity to give it.

Commonwealth has $20 million in real estate assets of which 40% is in office buildings, 14% equity interest in a joint venture office complex, and 44% shopping centers. If the 60% interest in the joint venture is carried over line-by-line to the Commonwealth balance sheets (see discussion of San Francisco REIT's accounting change on p. 8), real estate investment would total $37 million, of which 70% would be office buildings, broken down into 49% in the joint venture investment and 21% in wholly owned buildings.

Given this breakdown, we feel that the income generated from Commonwealth's investments is inadequate for a No. 1 ranking. The joint venture investment, 60% of VFEM Associates, had an operating loss equal to 9.3% of income from investments, while the three shopping centers contributed 127% of investment income, although constituting 32% of the real estate portfolio.

Since the April 11 issue, new developments have reinforced our opinion concerning the trust. On April 14, it announced that County and New Town Properties (CNT), a subsidiary of a U.K. concern and owner of 43% of the trust's shares, had offered to purchase an additional 12% for $11.50/share. The next day, the trust corrected that to say that the purchase was only being discussed. In reaction to this, the shares remained at the $8 level, indicating little confidence and indicating confusion. We stay with our No. 3 ranking.

BLOCK HOLDINGS:

American Financial Corp. has acquired $24.2 million of Chase Manhattan Mortgage & Realty's $108.3 million public debt, purchasing $6.1 million of 7-7/8% notes, $9.3 million of 7.5% subordintated debt, $4.4 million of 11-5/8% subordinated debt, $4.4 million of 6.5% debt, and $67,500 of 6.75% debt. The debt was purchased for 33.5% below total face value.

If the court approves the modified reorganization for the trust under Chapter XI, American Financial stands to receive common and convertible preferred shares equal to a total 11.8 million of common shares, or about 19% of total common on a fully diluted basis. American Financial also would receive $10 million in cash. The company said it had no immediate plans for its investment in the trust. American Financial also has holdings in Compass Inv., Kenilworth Realty, North American Mtg., and First Mortgage.

The group of dissident shareholders headed by Sidney M. Baer, a Philadelphia insurance executive, has asked a court to rescind Fidelco Growth Investors' sale of 400,000 new Fidelco stock to U.S. Lend Lease Inc. Included in the sale was a condominium project and a five-year warrant to purchase 400,000 more shares at $5 each.

The group, which had controled 23% of Fidelco's shares, has been engaged in a proxy fight for control of the company, and charges that trustees had issued the new stock to create votes in favor of management. They claim that the transaction should have been put to a vote, and that too little had been asked for the shares. Following the transaction, the group's interest in the trust shares fell to 19%, while Lend Lease assumed a 19% interest; if they exercise the warrants, they would have a 37% interest.

Among other block holders: Continental Illinois Corp. has purchased 4.2%

of Great American M&I, joining Edward Morgens and Bruce Waterfall, who have upped their stake to 16.2%. SZRL Investments has purchased 5.1% of Hamilton Investment; the group also has holdings in Clevetrust Realty. DeRance Inc., a Milwaukee-based charitable foundation, has raised its stakes in Realty & Mortgage Pacific to 5.1% and in Wells Fargo Mtg. to 5.6%; the company also has holdings in BankAmerica Realty, Gould, Growth Realty, Hotel Inv., Hubbard, IRT Prop., ICM Realty, Nationwide, Penna. REIT, REIT of America, and Wisconsin.

Also: Unicorp Financial has raised its stake in GREIT Realty to 29.1%; the company also owns shares in San Francisco REIT, REIT of America, and First Union. Pilot Industries has purchased 5.6% of Henry S. Miller. Intermark has raised its Mission Inv. stake to 20.0%. And B.F. Saul Co. has increased its interest in B.F. Saul REIT to 21.0%.

STOCK PAIRINGS

Washington REIT is joining the group of trusts considering changing to a paired corporation. At the same time, the trust is seeking shareholder approval for the trustees to restrict ownership of the shares. Since the issuing of a paired stock is not contingent upon the ability to restrict ownership, this can be viewed as a move by the trustees to prevent sizable inimicable shareholder positions.

Hotel Investors has now received a favorable ruling from the IRS on its proposed stock pairing; the only step left is to procure shareholder approval at a special meeting to be held this summer.

ACCOUNTING CHANGES

In accordance with new accounting guidelines, San Francisco REIT is now accounting for its investments in joint ventures with the equity method. Previously, the trust accounted for these investments by reporting its share of joint venture revenues and expenses in its income statements and its share of joint venture assets and liabilities on its balance sheets. With the change, only net figures are reported.

In its 1979 annual report, the trust presented both income statement and balance sheet figures using the prior and current method of accounting. With the new method, the trust is reporting \$3.9 million less in rental income and \$3.3 million less in expenses, for equity of \$0.6 million in joint venture earnings. Similarly, total assets and total liability figures were reduced by \$13.4 million, or 22% of the bottom line figure under the prior method. The magnitude of the figure is accounted for in that three of the trust's seven office building holdings are 50% owned. Net income and shareholder equity figures are unaffected.

The trust was opposed to the change on the grounds the trust is affected by the performance of earning assets in proportion to the size of trust investment, whether or not they own all of it. But the change does have the result of making the trust appear much more conservatively financed; its debt/equity ratio went from 1.2X under the old method to 0.7X under the new.

Clearly the effect of such a change can either hide or augment problem areas, refer to the discussion on Commonwealth, page 7, for an example.

On another front, the trust has issued a prospectus covering 1,348,000 common shares reserved for issuance upon exercise of outstanding warrants for the purchase of trust shares at an exercise price of \$25/share. The shares went as high as \$25.50 in January 1980; currently they are trading at around \$22.25. The warrants, trading at \$1, expire at 1980 year-end.